

**Testimony before the Committee on Ways and Means  
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**Key Elements of the German Corporate Tax System**

**Statement of Jorg Menger**

Mr. Chairman, Mr. Ranking Member and other members of this distinguished Committee, thank you for the honor to participate in these hearings on international tax reform. My name is Jorg Menger. I serve as an international tax partner of the German tax and accounting firm Ernst & Young GmbH, currently assigned to the New York office of Ernst & Young LLP, the US member firm of Ernst & Young Global Ltd. I appear before you today on my own behalf and not on behalf of Ernst & Young or any client of Ernst & Young.

The purpose of this statement is to provide a brief overview of the German corporate tax system, in particular concerning the tax treatment of foreign income earned by German corporations. The outline will also cover the historic roots of the current system. In the interest of presenting a concise statement, I will refrain, to the extent possible, from tax technical and academic citations.

A comprehensive German corporate tax code was enacted for the first time in 1920 and was subjected in the successive decades to multiple reforms. The current German corporate tax system became effective in 2001 and is based on a “classical” system of taxation at the corporate and shareholder levels. The introduction of the 2001 system was in particular driven by the need to integrate the German corporate tax system within the framework of case law issued by the European Court of Justice, which generally prohibits the member states of the European Union from discriminating for tax purposes between domestic companies and companies resident in another member state of the European Union.

In my remarks here, I will focus on the following major components of German tax policy:

- The current treatment of a corporation’s earnings at the level of the corporation and its shareholders;
- The current and historical treatment of dividend income received by a German corporation from its German and foreign subsidiaries;
- The current and historical treatment of capital gains from the disposition of shares in a German or foreign corporation (share capital gains) realized by a German corporation;
- The treatment of other foreign source income, such as branch income and royalty income;
- The tax deductibility of business expenses connected to the generation of foreign source income;

- The German controlled foreign company rules, which govern the immediate imposition of German tax on certain income generated by a controlled foreign company;
- The German framework governing the exchange of goods and services between related group companies (“transfer pricing”).

German tax policymakers have long focused on the successful implementation of a system of foreign source taxation that is governed by the principle of capital import neutrality, also defined as “competitive neutrality.” This policy culminated in the 2001 corporate income tax reform, which introduced a broad exemption system on all dividends and share capital gains earned by German corporations, regardless of whether from domestic or foreign sources.

### Taxation of German Corporations

Under the current German corporate tax code, German corporations are subject to corporate income tax on worldwide earnings, taxed at a rate of 15.825%. In addition, German corporations are subject to a second business income tax, known as “trade tax.” Trade tax is levied on taxable income as determined for corporate income tax purposes, subject to a few adjustments. The trade tax rate is set by the German municipalities in which the corporation’s business is carried out, and varies between 7% and 17%. The average German trade tax rate is 14%, so that the total average German income tax rate for a corporation is typically slightly below 30%.

### Current System for Taxation of Dividends and Share Gains

To avoid double taxation on corporate earnings distributed within a chain of corporations, the German corporate tax code employs an exemption system for dividends distributed by a corporation to another corporation. Generally, 95% of any dividends received by a corporation are exempt from tax, and thus only 5% of the dividend income is included in taxable income. The tax policy rationale for the 5% income inclusion is to act as a compensating offset for the deduction of business expenses that are directly related to the exempt dividend income. Thus, the German tax code allows the deduction of any business expenses even if they could be related to the ownership of the shares of the distributing company, such as stewardship expenses and financing costs attributable to the shares. As described below, the rules in this regard were different before the 2001 corporate tax reform and generally disallowed deductions for expenses that could be directly traced to exempt dividend income. The implementation of the 5% inclusion rule, which is backed by the European Union’s Dividend Directive, ended a constant conflict between German taxpayers and the German tax authorities concerning the circumstances under which taxpayer expenses directly associated with dividend income could be disallowed under prior law. This development represents a simplification of the overall German framework for the taxation of foreign source income.

The 95% exemption applies also to capital gains realized by a corporation through the sale of shares in another corporation. The 95% exemption applies to dividends or capital gains realized from any share in a corporation, regardless of the size of the interest held in the distributing corporation. The exemption also applies without regard to the holding period for the shares in the distributing company.

Finally, any capital losses from the disposition of shares in a corporation, or upon a liquidation of a corporation, are not deductible.

As a final note, the dividend and share capital gain exemption generally does not apply to portfolio investment income realized by life and health care insurers, and to portfolio short term trading income realized by financial institutions. In these situations, dividend income and share capital gains are fully taxable, and capital losses are fully deductible. This exception was included in the German corporate tax code in 2003 and was originally initiated by policy requests from the relevant industry which had suffered from heavy portfolio losses caused by the stock market's decline following the burst of the internet bubble at the beginning of the new millennium. The exception does not apply with respect to income from 10% or greater interests in companies based in the European Union or in most tax treaty jurisdictions (and the 95% exemption applies to such income).

The 95% exemption also is relevant for purposes of the trade tax, which is the second German business income tax. In the case of dividends, the exemption applies for trade tax purposes only for corporate taxpayers that own a significant interest in the distributing corporation, and eligibility for the exemption is subject to additional requirements if the distributing entity is outside the European Union. Generally, the trade tax code grants the 95% dividend exemption only to shareholders that have owned an interest in the distributing corporation of at least 15% since January 1 of the year in which the distribution occurs. If the distributing corporation is resident outside the European Union, the exemption applies only if the shareholder renders proof that the income of the foreign distributing corporation is exclusively generated by what is known as "active trade or business" operations (this concept is discussed in more detail below). Moreover, exemption from trade tax on dividends can be granted under tax treaty exemption provisions (which will be discussed more fully below). In the case of share capital gains, the trade tax code is fully synchronized with the corporate tax code and a 95% exemption applies to such gain.

#### Historical System for Taxation of Dividends and Share Gains

The current exemption system applies to both domestic and foreign source dividends and share gains. Historically, however, the German tax system had an exemption system only for foreign dividends and share capital gains, which was in place many years before 2001. The current system is a product of the earlier exemption systems.

The 1920 and 1925 corporate income tax code included a version of an exemption for dividend income. In the 1950s, Germany started the development of a modern tax treaty network that was governed by OECD principles. The first modern tax treaty of this era was concluded in 1954 with the United States, and included an exemption from German corporate income and trade tax for dividends received by a German corporate shareholder from a distributing US corporation. This 100% exemption was combined with rules that disallowed deductions for certain expenses directly related to the ownership of the shares determined using a tracing approach. This dividend exemption rule was, with some variations, included in all subsequently ratified German tax treaties. Because the exemption was provided by treaty, the conditions varied somewhat from treaty to treaty and some treaties included an

active trade or business requirement. The German corporate income tax code included rules that unified the required ownership percentages for the treaty-based dividend exemption providing for exemption on a unilateral basis for dividends from an investment of at least 10% in the distributing foreign corporation. More recently, the German corporate income tax also included provisions that extended the dividend exemption to capital gains.

Parallel to this, as a solution for dividends from foreign companies not resident in treaty jurisdictions, Germany introduced in 1972 an indirect foreign tax credit provision into the corporate income tax code. Similar to current US provisions, the indirect foreign tax credit rules allowed the tax paid by a foreign corporation to be credited against the German corporate income tax levied upon the dividend distribution. The indirect credit applied only in non-treaty cases.

To summarize the historical and current German tax treatment of dividends and capital gains: Beginning in the 1950s and in the context of the development of an extensive tax treaty network, dividends distributed by foreign companies to German corporations were exempt from German taxation subject to satisfaction of the qualifying conditions specified in the particular treaty. This treaty-based exemption was supplemented in 1972 with an indirect foreign tax credit for distributions made by non treaty based companies. The treaty-based exemption also was extended to capital gains realized on the disposition of shares. Since 2001, these rules have been replaced with a 95% exemption for dividends and capital gains received with respect to shares in both foreign and domestic corporations. Some exceptions apply to this exemption, most notably the imposition of trade tax on portfolio dividends (which are paid on a shareholding of less than 15%).

#### Taxation of Foreign Branches

Income generated by foreign branches of a German company is generally exempt from German taxation, if the branch is located in a treaty jurisdiction. For branches located in a non-treaty jurisdiction, the German corporate income tax code provides for a foreign tax credit. Foreign branch income is not subject to trade tax. Income from foreign real estate is also exempted under most German tax treaties; only a few German treaties revert to the foreign tax credit method on income from real estate. Many German tax treaties, including the US / German treaty, require that the relevant foreign income be taxed in the other treaty state in order to be eligible for the exemption, and this requirement has been incorporated into the German income tax code.

Expenses which were incurred by the taxpayer to generate foreign exempt branch or real estate income and which can be economically traced to a foreign investment (such as interest paid on acquisition financing) cannot be deducted. Otherwise, business expenses generally are deductible.

#### Taxation of Other Foreign Income

Any other foreign source income, such as royalty or interest income, is taxable, and a credit for foreign taxes, if any, generally is allowed against the German tax.

#### Taxation of Controlled Foreign Companies

The Foreign Tax Act was enacted in 1972 and goes back in its origins to the U.S. controlled foreign corporation rules, which were introduced in the 1960s in the United States. In principle, German Foreign Tax Act provisions subject undistributed income of a controlled foreign company to German corporate income and trade tax, generally if such income is of a passive nature and is not subject to income tax in the foreign country at an effective rate of at least 25%. However, in the case of a controlled foreign company that is resident in an EU country, these rules apply only as an anti-abuse measure in more narrowly defined circumstances.

For purposes of the Foreign Tax Act, a controlled foreign company is any company that is directly or indirectly owned or controlled more than 50% by German residents. If the foreign company receives income from capital investment (interest, income from derivatives and other financial instruments other than dividend income), the more than 50% ownership threshold is reduced to 1%. Passive income is defined in the negative, and comprises any income which is not perceived as income derived from substantial and true commercial operations or so-called “active” or “good” income. Good, active income is described in ten sub-categories:

- Farming income;
- Manufacturing, mining and oil and gas activities, generation of energy;
- Insurance or banking income of a “commercially established” insurer or financial institution;
- Trading income, except for certain trading activities between related parties;
- Service income, unless services are provided with the substantial assistance of a German resident;
- Income from real estate and other property lease income, provided that the real estate income would be exempted under a treaty had it been directly allocated to a German taxpayer. Other property lease income is good income, if generated without the substantial assistance of German resident shareholders and the foreign lessor operates as a fully commercially equipped enterprise. This category also includes royalty income, if derived from the exploitation of intangibles that were self-developed by the controlled foreign company;
- Income from financing companies which source investment capital from unrelated parties;
- Dividend income;
- Share capital gain, unless the underlying appreciation is based on income from capital investment;
- Certain foreign reorganization gains.

Most investment income (except dividends) constitutes passive income and, if low taxed, is subject to full corporate and trade tax at the level of the German parent. However, low-taxed passive income of a subsidiary that is resident in a European Union member state is only subject to German tax under these provisions if it is generated within an abusive scheme. This generally would not be the case if the subsidiary carries on its own genuine business activities; that is, if the subsidiary interacts with its own personnel and follows its own business agenda to a not immaterial extent in outside commercial

markets. Foreign Tax Act rules apply also to branch income of a German taxpayer, which is exempt under a treaty, and provide for immediate income inclusion, if the same income would have been taxed under these rules had it been generated by a controlled foreign company.

### Transfer Pricing

Germany secures the correct taxation of domestic earnings within a group of related companies through an elaborate network of transfer pricing provisions, transfer pricing regulations and transfer pricing documentation obligations, all developed under the guidelines of OECD principles.

In summary, Germany has successfully implemented a system of taxation of foreign earnings, which is driven by two principles: competitive neutrality and simplicity. From a tax policy perspective, Germany started to follow a strict competitive neutrality approach with respect to foreign source earnings as early as 1950 in the context of a very high-tax German domestic environment. It was in the early 1990s that the overall tax burden on undistributed corporate earnings began to decline in the course of a series of reforms, from an effective rate of up to approximately 65% to today's 30% rate.

Thank you for giving me the opportunity to share this information on the German tax system. I would be happy to answer any questions from Members of the Committee.